CITY OF LODI
INFORMAL INFORMATIONAL MEETING
"SHIRTSLEEVE" SESSION
CARNEGIE FORUM, 305 WEST PINE STREET
TUESDAY, OCTOBER 18, 2005

An Informal Informational Meeting ("Shirtsleeve" Session) of the Lodi City Council was held Tuesday, October 18, 2005, commencing at 7:02 a.m.

A. ROLL CALL

Present: Council Members – Hansen, Hitchcock, Johnson, and Mounce

Absent: Council Members – Mayor Beckman

Also Present: City Manager King, City Attorney Schwabauer, and Deputy City Clerk Perrin

B. TOPIC(S)

B-1 "Update on Electric Utility's financial position, Market Cost Adjustment, and recent power purchases"

Interim Electric Utility Director, Dave Dockham, stated that the Market Cost Adjustment (MCA) process is the second step in a three-step process, which began with the power purchase to procure the City's net short position in order to stabilize the power cost. The second step is to get the revenues and expenses back into balance on a fiscal year basis, which staff is proposing to accomplish through the MCA. The third step will be to implement the long-term financial rate structure and to "true up" the rates that will be adjusted through the MCA so that they more accurately reflect what the financial structure of Electric Utility actually is.

The City purchased enough energy to fill 95% of the need. For the months of November to June, power was procured at a cost of $11.6 million. Because the month of October had already begun, staff was unable to purchase out on a forward basis and instead did a "balance of the month" purchase of approximately $0.6 million. Additionally in September, there was a small open position, which amounted to $100,000; therefore, for the September to June period, the total procurement for the net open position was $12.3 million. When the request to purchase was made three weeks ago, staff anticipated that the cost would be $13.1 million.

The Northern California Power Agency (NCPA) has four geothermal turbines in the Lake County area, one of which failed. All NCPA members that participate in this project received a pro-rata reduction due to the one unit failing; therefore, in order to return to the 95% level, staff will need to procure approximately 6% additional need for November and December. The estimated cost for this purchase is $250,000 a month. In terms of procuring 95% versus 90% of the net open position, there is very little difference in how much volatility occurs in the actual procurement costs; however, staff will work with NCPA to determine the optimum time to close that position.

City Manager King explained that the City sets its target at 95% equals 100%. The reason for this is that the demand variable is unknown and cannot be controlled, and the City should not over procure its power. Once purchased, the City must use or lose the power and cannot sell it. At the 95% level, if customers do not consume more than what the City purchased, it has not over bought, but if it goes above 95% or the demand increases, the differential could be purchased. It is probable that once the MCA is implemented customers will conserve in order to control their costs and the City could see a decrease in the demand.

Mr. Dockham reported that the Electric Utility Department has 30 plus divisions within the budget and outlined the four core functions:

1) Administration, which provides management and administrative services to the entire department – $1.1 million;
2) Construction and Maintenance, which includes the line crews that perform the overhead and underground maintenance, new construction, technical services that handle the substation construction and maintenance, and the troubleshooting division that handles customer problems or outages on the system – $3.7 million;
3) Business Planning and Marketing, which functions include rate forecasting, budgeting, field service metering, and the public benefits program – $1.5 million (NOTE: The public benefits program represents approximately half and is a state mandated program); and
4) Engineering and Operations, which functions include designing of enhancements to the system, working with developers to extend facilities to new development projects, metering, and utilities operations that provide dispatch services to both the Electric and Public Works Departments – $2.1 million (NOTE: Public Works helps fund the dispatch services at $500,000 per year).

Sixty-five percent of the total Electric Utility budget is related to bulk power costs, and 8% is in debt, which equates to 73% of the department expenses that are non-discretionary. Over time, there will be an opportunity to reduce bulk power costs; however, presently there is a very high market and forward prices that are not moving. In terms of future cost reductions, it has to come from Operations and Maintenance, which has already seen a 20% reduction; any further cuts will affect City services.

On the revenue side, virtually all of the income comes from power sales, with a small amount from investments and bonds. Previously, there was a much more sizeable interest income, but as those bonds have been used in operating the Utility, the interest income has diminished. Additional revenue includes the payments from Public Works for the dispatching services, income from developers, and accident repayment. The total revenues are $56.7 million and total expenses are $55.9 million; since fiscal year 2003, Electric Utility has been operating at a loss every year and it has been increasing over time. Fiscal year 2005-06 began with an $8.3 million deficit, but with the addition of the power purchase and the 20% reductions in the Operating and Maintenance expenses, staff was able to get the increase limited to $900,000 instead of $3 million. There is still a savings account that is available to offset the fact that the Utility is operating in a deficit condition. As part of the budget, it was expected that the savings account would be completely eliminated and the City would have a $2.2 million deficit this year; however, at the end of last year, the fund balance was slightly higher than originally anticipated, and the deficit was reduced to $1 million. f the MCA is not implemented, the Utility will continue to operate in a deficit condition. If the MCA is applied, the City will have $3.4 million in the savings account at the end of the year.

The causes of the revenue in-balance are primarily driven by the rapidly increasing cost of power supply, no rate adjustments since 2002, and a series of heavily-discounted rates for the largest commercial and industrial customers. In 2003, the power supply cost was $30 million a year. In 2004, the power supply cost increased by 5% over the prior year, 2.5% in 2005 over the previous year, and as budgeted in 2006, it was estimated at 20% over last year; however, as 2006 materialized, it actually increased by 29%. Overall, power costs increased nearly 39% since the last MCA in November 2002.

Council Member Johnson questioned the possibility of building in a cost of living adjustment to the electric utility rates, as was done with the recent water rate increase.

Mr. Dockham stated that, had Lodi raised rates systematically over the last four years, the increase in the first year would have been 1%, the next year 3%, then 7%, and for this year 11%. Over time, the impact of the increase the City is facing now could have been much less had it followed this systematic increasing of rates over the last four years.

Mr. King compared the difference of a cost of living adjustment for water versus electric rates. The basic costs for water remain constant (i.e. infrastructure and operational costs are the biggest drivers, which tend to change more slowly). For electricity, there is a commodity cost that has rapidly increased, and a Consumer Price Index cost of living adjustment would not have been sufficient.

Council Member Hansen stated that the Council needs to understand what is occurring and make a policy decision on whether or not from this point forward it will factor in market cost increases in order to avoid a similar situation from occurring again.

Mayor Pro Tempore Hitchcock pointed out that the MCA is the adjusting factor; however, it has not been implemented. At the American Public Power Association conference, it was clear that a MCA was the standard used for making adjustments to the market cost of power.

City Manager King was unaware of the reason why the MCA was not utilized from 2002 to present and he felt that staff should further explore how to implement the MCA in a more streamlined fashion, yet still include the Council in its oversight responsibility.

Mayor Pro Tempore Hitchcock questioned if it would have made a difference had the City not waited so long to purchase power, to which Mr. Dockham replied that it would have been $3.4 million less expensive (i.e. a 20% increase over the previous year versus 29%).

Mr. Dockham stated that quarterly updates would be provided to the Council on the water and electric utility rates, which would be an opportunity for the operating departments to inform Council how the MCA is working and whether a rate adjustment is necessary.

The City offers a discounted rate off of the published rate to a number of contract customers as an economic stimulus. These customers were on a contract for several years before 2003, and when those contracts terminated, the customers were to either move to the published rate or be phased in over a period of time. The decision was made to phase them in over a four-year period, and there should have been a steady progression up to the published rate; however, the increase has continued to be minimal due to the fact that the City is operating at a deficit. Electric Utility staff will be meeting with the contract customers to explain the situation, as these customers will see the largest increases associated with the MCA recommendation.

In response to Council Member Hansen, Mr. Dockham stated that the contracts expired in 2001 and were renegotiated in 2003-04 with this four-year transition element, which would end in October 2006, bringing them to the full published rate. Approximately half of the revenue from the proposed MCA comes from this group.

City Attorney Schwabauer explained that these contracts do not set the rate; they set a discount percentage off of the published rate and do not inhibit the Council's ability to change the published rate.

In response to Mayor Pro Tempore Hitchcock, Mr. Dockham stated that these contracts represent approximately $5 million in lost revenue to the City. NCPA prepared a rate structure comparison of Lodi and other cities, which demonstrated that Lodi is far below every other city for industrial customers.

Council Member Hansen expressed concern about how the MCA would affect these commercial and industrial customers as it would have a huge effect on their budgets mid year.

Council Member Johnson requested a copy of the NCPA rate comparisons.

Mr. Dockham explained that the City must raise the electric rates, and there is an approved mechanism in place through the MCA, which was adopted by Council in 2001. A delay of this MCA only increases the need for a larger increase later. Each month, the Utility is $800,000 further into debt. If the City waits until December to implement a rate increase, it increases by 1.2% over the 19.5% average that staff is requesting now and will continue to multiply geometrically.

To determine the MCA, staff began with an abbreviated cost of service analysis by considering each class of customer in the City and assigning costs incurred to each. Staff used information from 2005, scaled it up for 2006, and then compared the power supply expenses to the revenues that were generated from each of the rate classes. The MCA was arrived at by dividing the total amount needed by the total kilowatt (kw) of consumption in each class. The rates were then tiered in order to keep them equal to or less than Pacific Gas & Electric's (PG&E) rates.

There are 19,000 customers in the residential class; it costs 10.5 cents per kw hour to procure energy for this group and the City collects 5.8 cents per kw hour. The difference between the two is a MCA of 4.5 cents. To collect this beginning in November, the MCA would need to be 7.3 cents per kw hour; however, in order to stay below PG&E, the maximum increase would be 4.3 cents per kw hour. The average consumption for the residential class is 700 kw per month; at this consumption level, Lodi's rates are currently above PG&E's. PG&E's rates begin increasing rapidly in the higher levels of consumption. Under the proposal, Lodi's rates would be above PG&E's until its "true up" (of approximately 11%) takes effect in January 2006, at which time Lodi's and PG&E's rates would be identical. A residential customer that uses around 700 kw hours per month would see either a decrease in rates or an increase of approximately 2%. About 65% of Lodi's residential customers fall in this range.

In the all electric class, 95% of the 600 customers use less than 1100 kw hours per month. Under the proposal, these customers would see a decrease in their electric rate.

In the low-income residential class, 80% of the 1,500 customers use below 800 kw hours per month. Included in this class are medical discount eligible customers and the low-income discounts. Under the proposal, there is a small increase. Mr. Dockham added that there is concern with the high consumption level in this class, as it is not conducive with the low-income structure, and staff will investigate this further.

In the residential mobile home class, there are six parks in town, which would see varying levels of increase. To calculate the increase, staff used the highest billing month in August, took the difference between what they are paying now and what they would be paying under the new rate, and divided that by the number of pads that exist in the park. This results in a spread of different increases per pad, because some of the mobile home owners receive medical or low-income discounts. The revenue generated from this group is $150,000. Staff recommends that this group be equivalent with residential customers and the mobile home rate be eliminated.

The commercial/industrial rates are as follows:

- G-1, small restaurants—little or no increase
- G-2, fast food stores—7.4% increase
- G-3, large grocery stores—22.5% increase
- G-4, large hardware stores—14.5% increase
- G-5, large high schools—15% increase

Step three would be to implement the long-term rate structure and financial plan for the Utility. More analysis needs to be done before staff can "true up" the rates and recommend a permanent financial structure. Fifty percent of the power supply for next year still needs to be procured. Should Lodi choose to become a participant in one of the power plant opportunities, there is some investment that would be required, which would affect the City's expense structure. If it came to fruition, the costs would be rolled into the overall financing of the plant; however, if it did not go forward, it is an expense that would be absorbed into the operating structure. Further analysis is needed on the City's debt structure. NCPA is working on a policy that would establish the maximum amount of variable rate debt that an agency can have and the criteria that it would use to determine whether it enters into a swap agreement.

Mr. Dockham reported that there are currently 14 vacant positions in Electric Utility and some key positions should be filled. Staff will assess whether the various capital improvement projects are critically needed or desirable and whether or not there is sufficient funding remaining from the financing to cover the essential projects. Another element is the Electric Utility service center and whether or not the proposed location would be advantageous. Staff will return with a proposal on what the financial structure of the Utility should look like. The MCA would indicate to financial rating agencies that the City is committed to getting its finances back in balance.

In response to Council Member Hansen, Mr. King reported that staff is assembling a list of candidates for the Electric Utility Director position using a targeted, selected recruitment process, scheduled to close on November 18. No decision has been made yet on the selection process, but the goal is to have a new director by the end of the year. Council Member Hansen requested that both he and Mayor Pro Tempore Hitchcock be included in the selection process based upon their experience with NCPA.

At the request of Council Member Johnson, Mr. Krueger reported that at the end of the last fiscal year, there was $7.5 million in the bank. If the City chooses not to implement a rate increase, there would be no reserves remaining.

Mr. King added that the proposed MCA would provide for greater revenues than expenses in the current fiscal year, but it would not make up for the deficit experienced in the past fiscal years.

Mayor Pro Tempore Hitchcock requested that additional information be provided to Council before the October 19 regular meeting, including the number of customers and the actual costs and percentage increases for residential, commercial, and industrial, similar to NCPA's rate comparison with other cities.

C. COMMENTS BY THE PUBLIC ON NON-AGENDA ITEMS

None.

D. ADJOURNMENT

No action was taken by the City Council. The meeting was adjourned at 8:29 a.m.

ATTEST:

Jennifer M. Perrin
Deputy City Clerk

MEMORANDUM
Office of the Lodi City Manager

TO: City Council

FROM: Jere Kersnar, Acting City Manager

DATE: October 14, 2005

SUBJECT: October 18, 2005, Shirtsleeve Session
"Update on Electric Utility's financial position, Market Cost Adjustment, and recent power purchases"

The purpose of this Shirtsleeve Session is to provide information to assist the City Council regarding its decision to implement a Market Cost Adjustment to the Electric Utility rates. Formal Council action on the matter is scheduled for the October 19, 2005, Regular City Council meeting.

At the Shirtsleeve Session, staff will deliver a PowerPoint presentation providing an update on Electric Utility's financial position and the proposed Market Cost Adjustment, as well as the recent power purchases.

JK/jmp

Update on Electric Utility’s financial position, Market Cost Adjustment and recent power purchases

City Council Shirtsleeve Session

October 18, 2005

Overview

- Financial focus will be on FY06
  - Financial results leading up to FY06
  - Brief treatment of finances post 2006
- Second step of three step process
  1. Stabilize purchase power costs
  2. Correct the Revenue/Expense Imbalance (MCA)
  3. Implement long term rate structure and financial plan

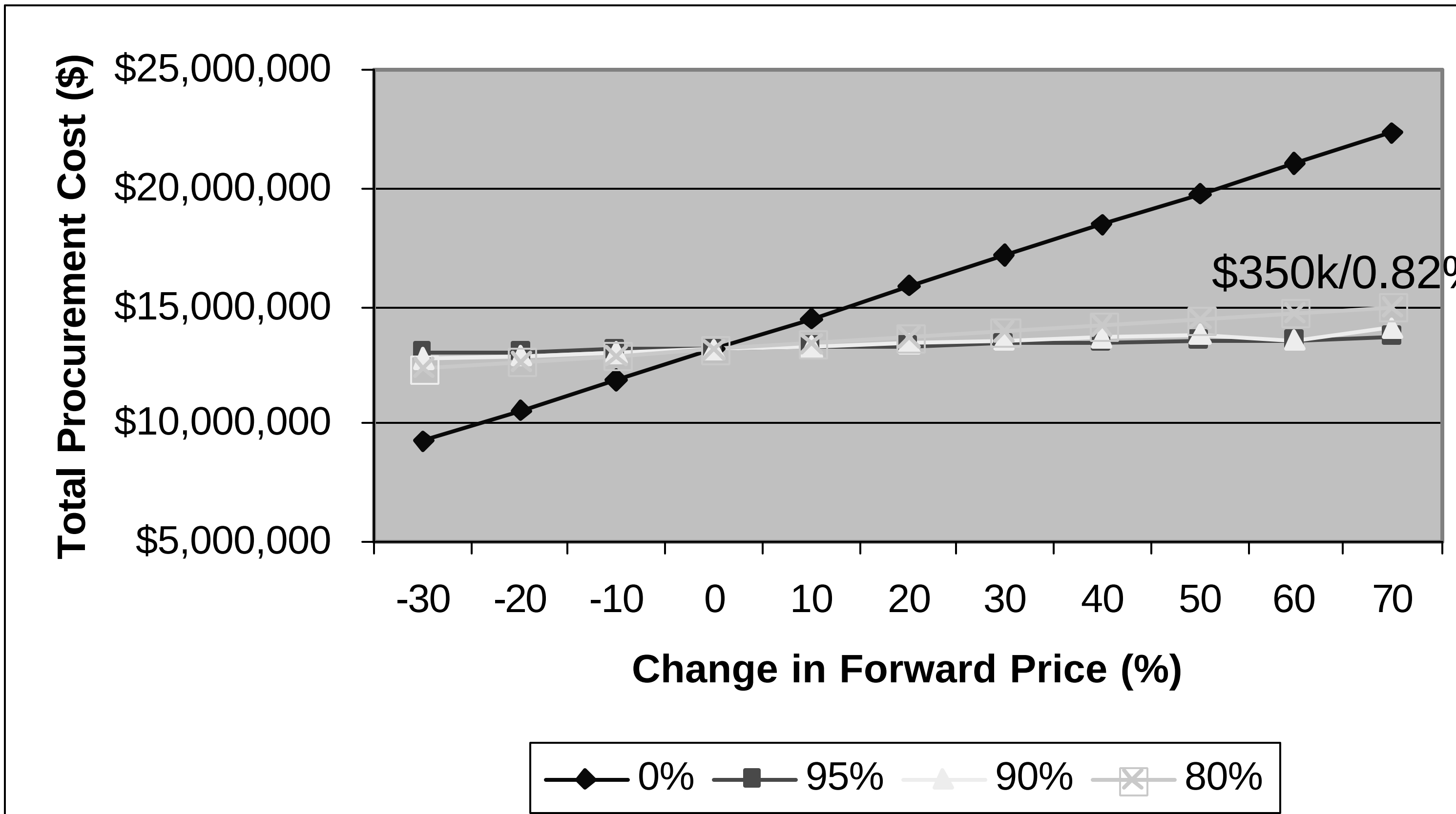
Stabilize Purchase Power Costs

November – June	$11.6 million
October balance of month	$ .6 million
Total	$12.2 million
September open position	$ .1 million
Total	$12.3 million
Estimate for purchase	$13.1 million
Reduction from estimate	$ .8 million

Ongoing results

- October prices have been choppy
- Future prices have stabilized or flattened
- Price volatility still a significant risk
- A turbine failure at NCPA’s Geo 4 plant has resulted in reduced output from plant to participants
  - Additional purchase needed to get to 95%
  - Represents approximately 6% of requirement in November and December
  - Estimated cost of $250k per month

Open Position Sensitivity to Price Changes (9/27/2005)



Organizational Background

Administration
$1.1 Million

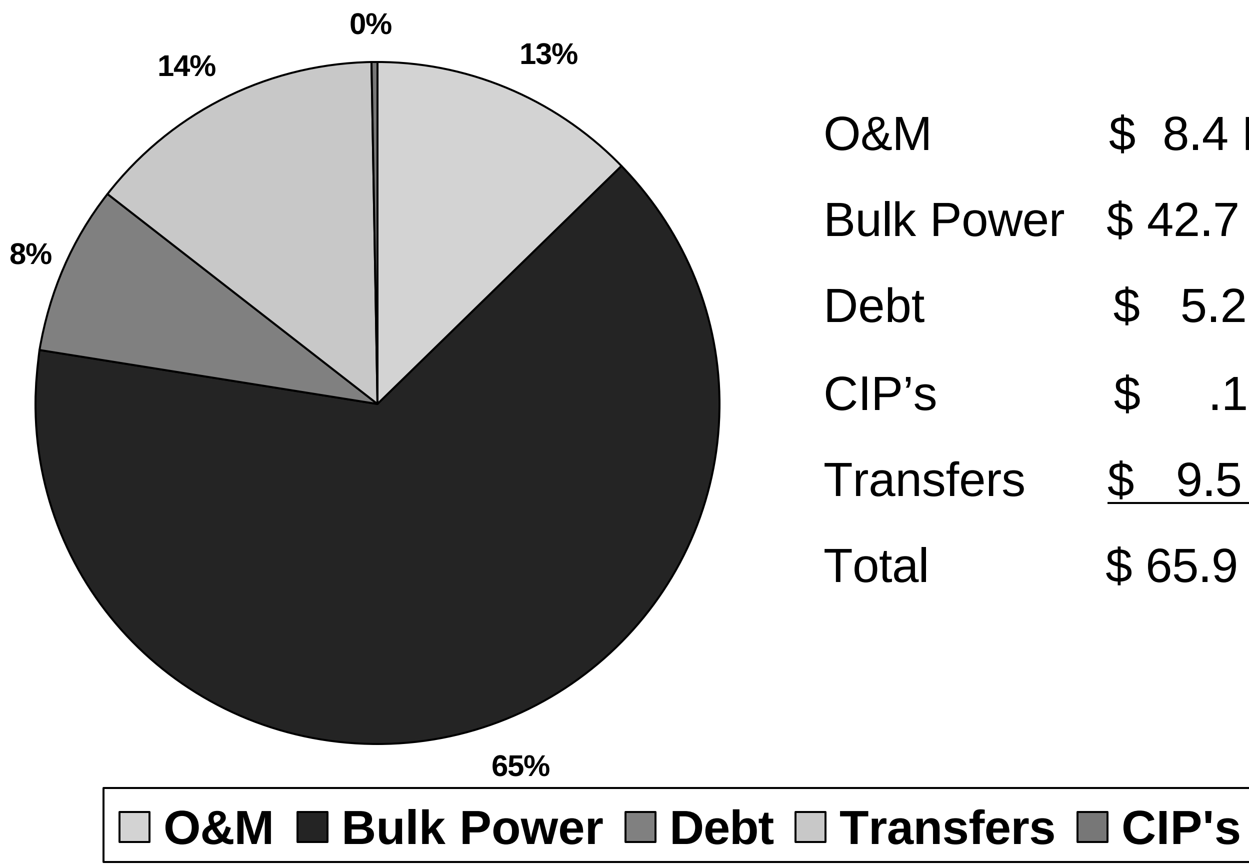
Construction &
Maintenance
$3.7 Million

Business Planning
& Marketing
$1.5 Million

Engineering &
Operations
$2.1 Million

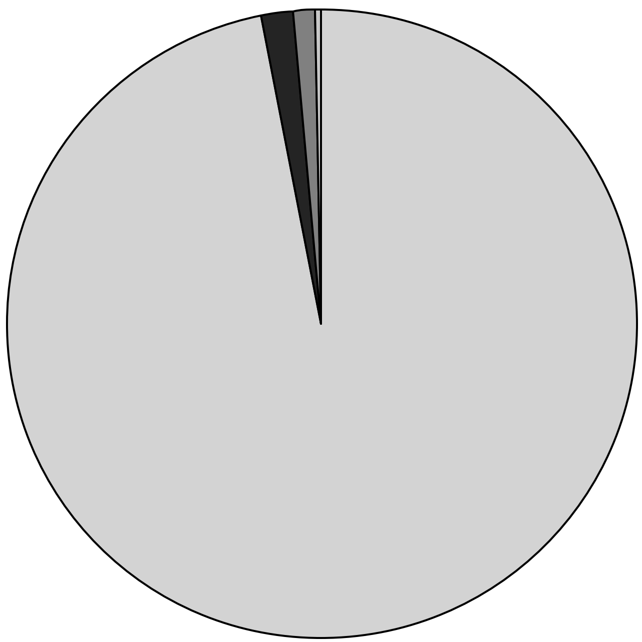
Electric O&M represents $8.4 Million of the $65.6 Million Electric Department Budget

Financial Structure - Expenses



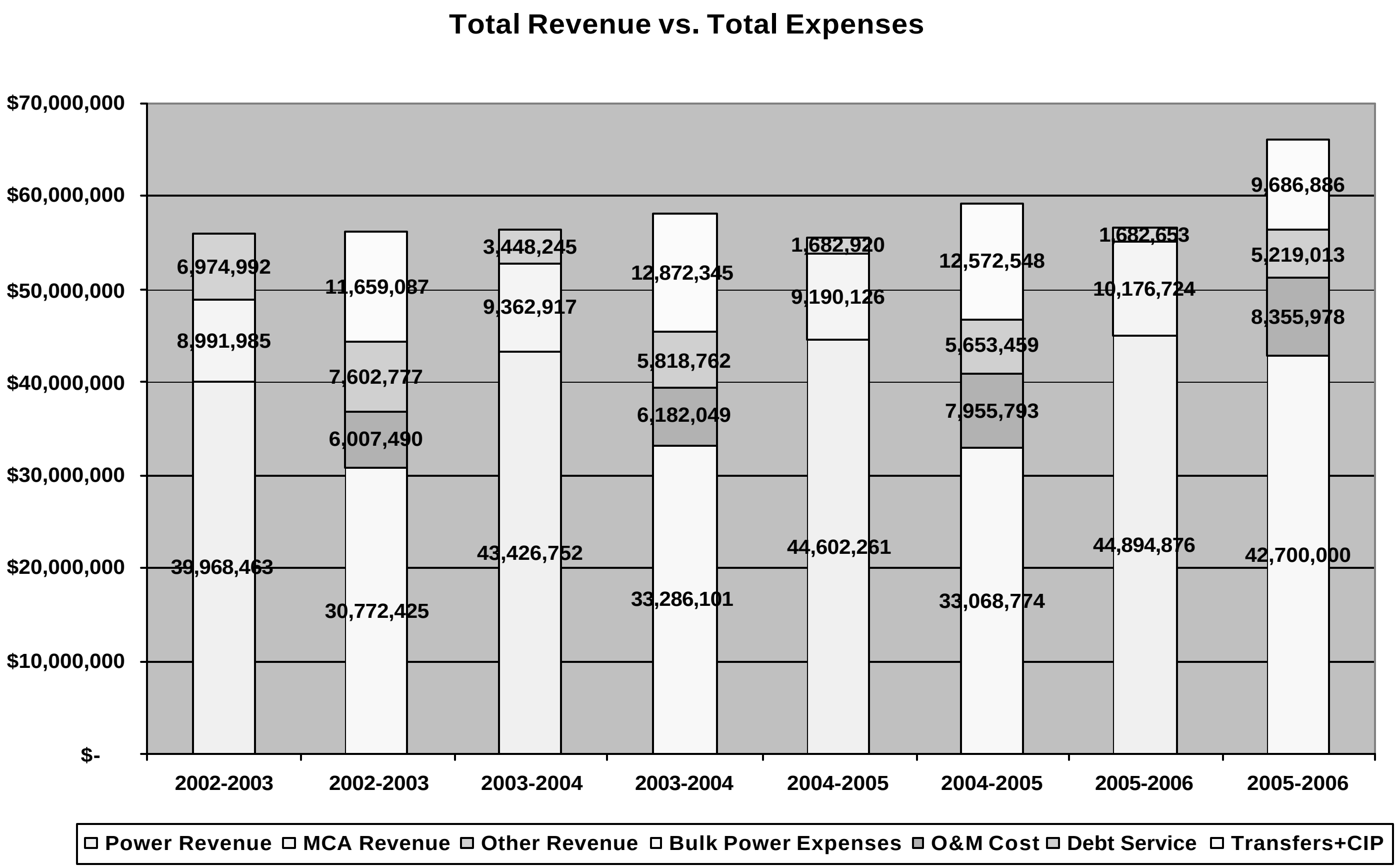
O&M	$ 8.4 Million
Bulk Power	$ 42.7 Million
Debt	$ 5.2 Million
CIP's	$ .1 Million
Transfers	$ 9.5 Million
Total	$ 65.9 Million

Financial Structure – Revenues

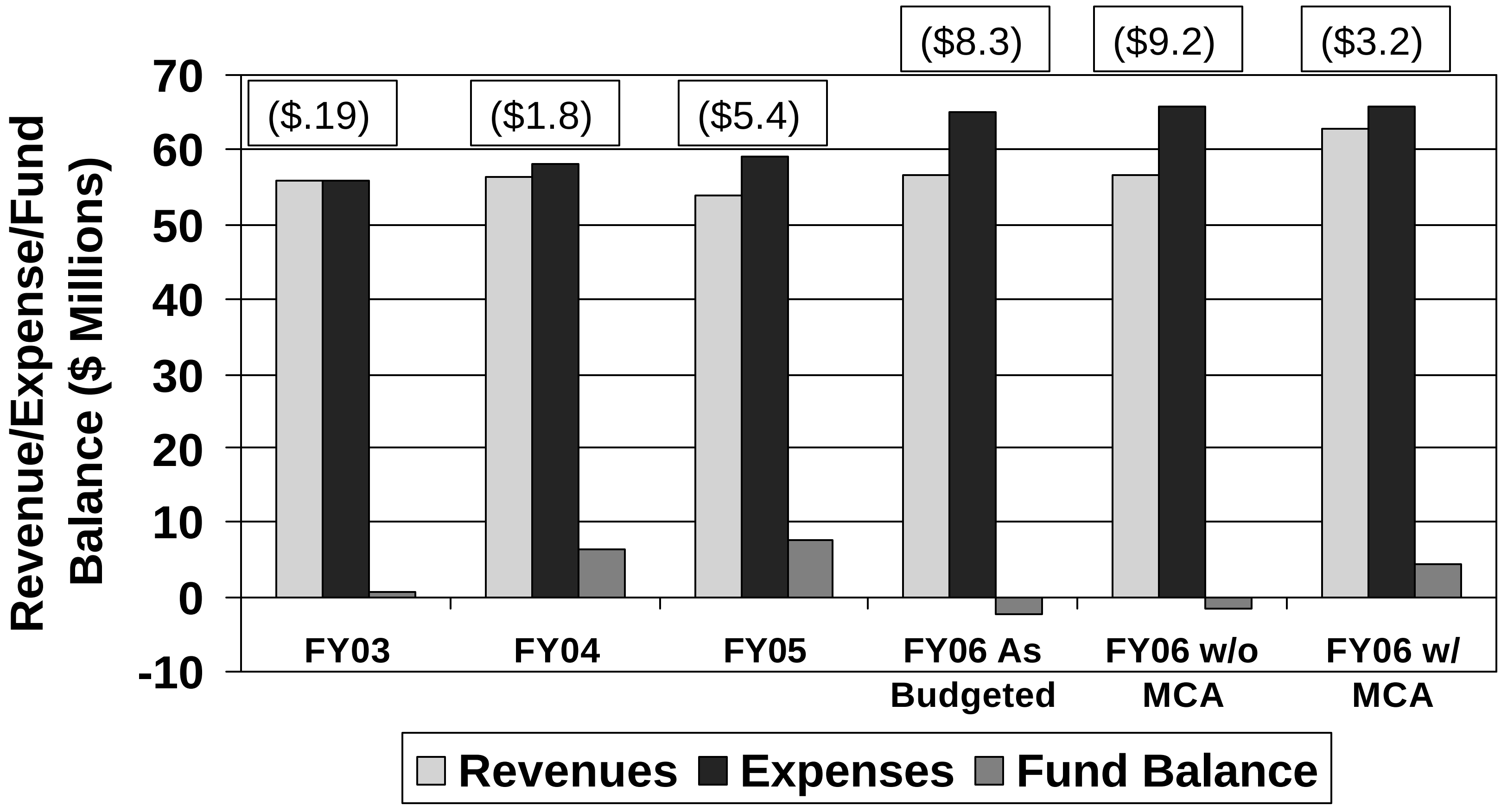


Power Sales	$ 55.1 Million
Investments	$ .95 Million
Services	$ .59 Million
Other	$ .14 Million
Total	$ 56.7 Million

Financial Structure – Revenues and Expenses



Cash Flow Analysis of Financial Structure



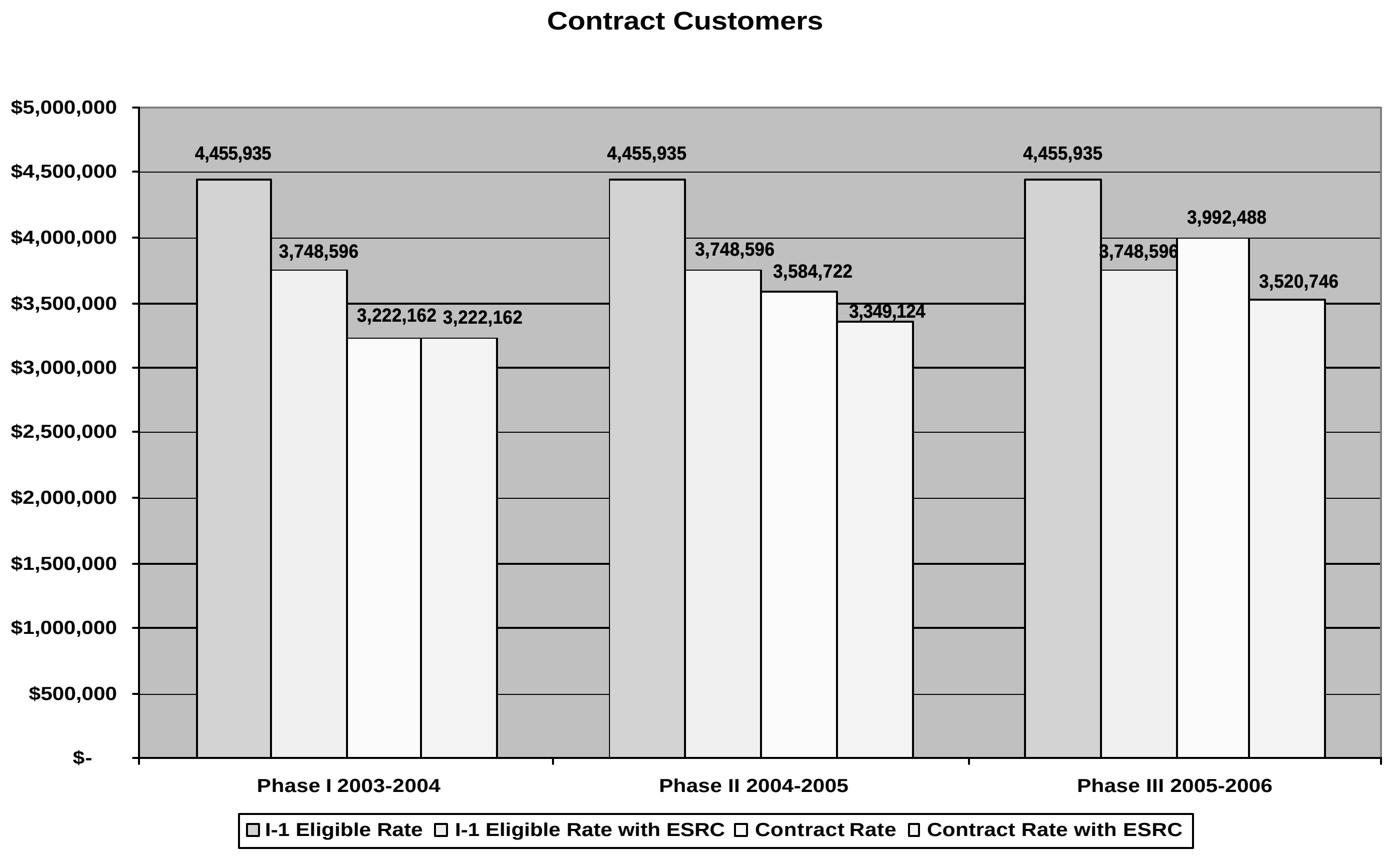
Causes of Revenue Imbalances

- Rapidly increasing costs of power supply in FY06
- No rate adjustments since 2002 to address generally increasing revenue and expense imbalances
- Discounted rates for largest users

Change in Power Supply Costs Over Time

	FY03	FY04	FY05	FY06 As Budgeted	FY06 As Forecast
Power Supply Cost ($M)	$30.8	$32.3	$33.1	$39.8	$42.7
% Change from prior year	n/a	4.9%	2.5%	20.2%	29.0%
% change from last MCA	n/a	4.9%	7.5%	29.2%	38.6%

Discounted Rate Issue



Market Cost Adjustment

- Need Established
  - Significant Increase in Power Supply Costs
- Approved Mechanism for Implementation in Place
  - Adopted by Ordinance 2001
  - Requires Council approval to implement changes
- Delay of implementation increases size of rate increase needed
  - Deficit approximately $800K per month
  - Each month delay requires 1.2% larger increase

How was MCA determined?

- Abbreviated Cost of Service Analysis Performed
  - Costs were assigned to each rate class based on actual costs from FY05 and scaled to FY06
  - Total expenses from each rate class were compared to revenue generated through rates for each rate class
    - revenues and expenses for each class were further subdivided into power supply and non power supply components
    - Differences between power supply revenues and expenses then represented the pool of dollars to be collected through the MCA
    - MCA rates were then developed to collect the necessary pool of dollars based on total consumption within each rate class
      - Limit on MCA to keep total rate less than or equal to PG&E

MCA Results - Residential

	Power COSA	Power Revenue	Implied MCA	MCA Short	Avg MCA
EA	$.1036	$.0585	$.0451	$.0728	$.0433
EE	$.1036	$.0484	$.0552	$.0891	$.0461
ED	$.1042	$.0506	$.0536	$.0864	$.0085
EM	$.0933	$.0493	$.0440	$.0710	$.0698
D to D	$.0894	$.0000	$.0894	$.1442	$.0100

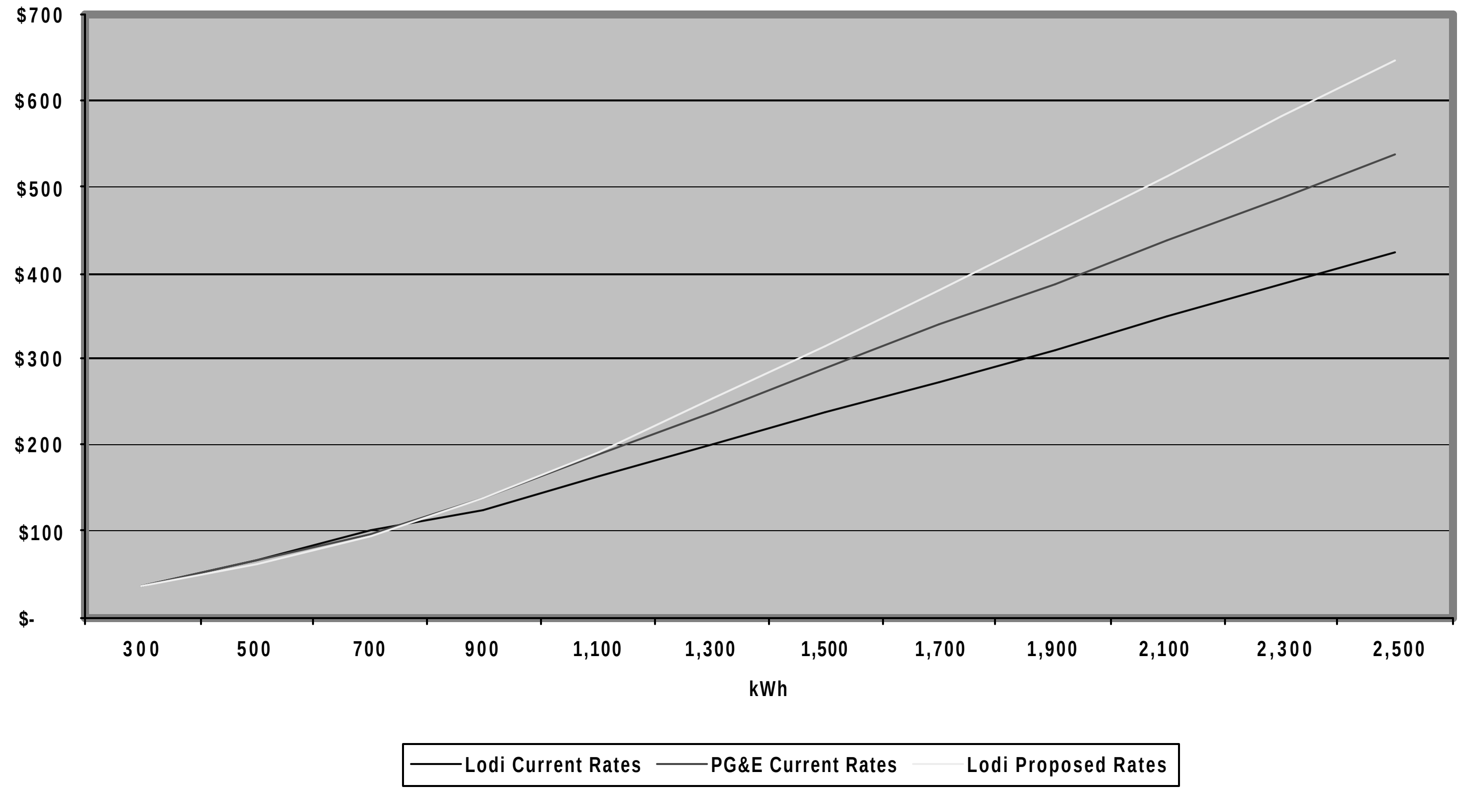
MCA Results - Commercial

	Power COSA	Power Cost	Implied MCA	MCA Short	Avg MCA
G1	$.1034	$.0632	$.0402	$.0649	$.0409
G2	$.0968	$.0514	$.0454	$.0732	$.0483
G3	$.0848	$.0571	$.0276	$.0446	$.0446
G4	$.0836	$.0525	$.0310	$.0500	$.0336
G5	$.0776	$.0545	$.0231	$.0373	$.0280

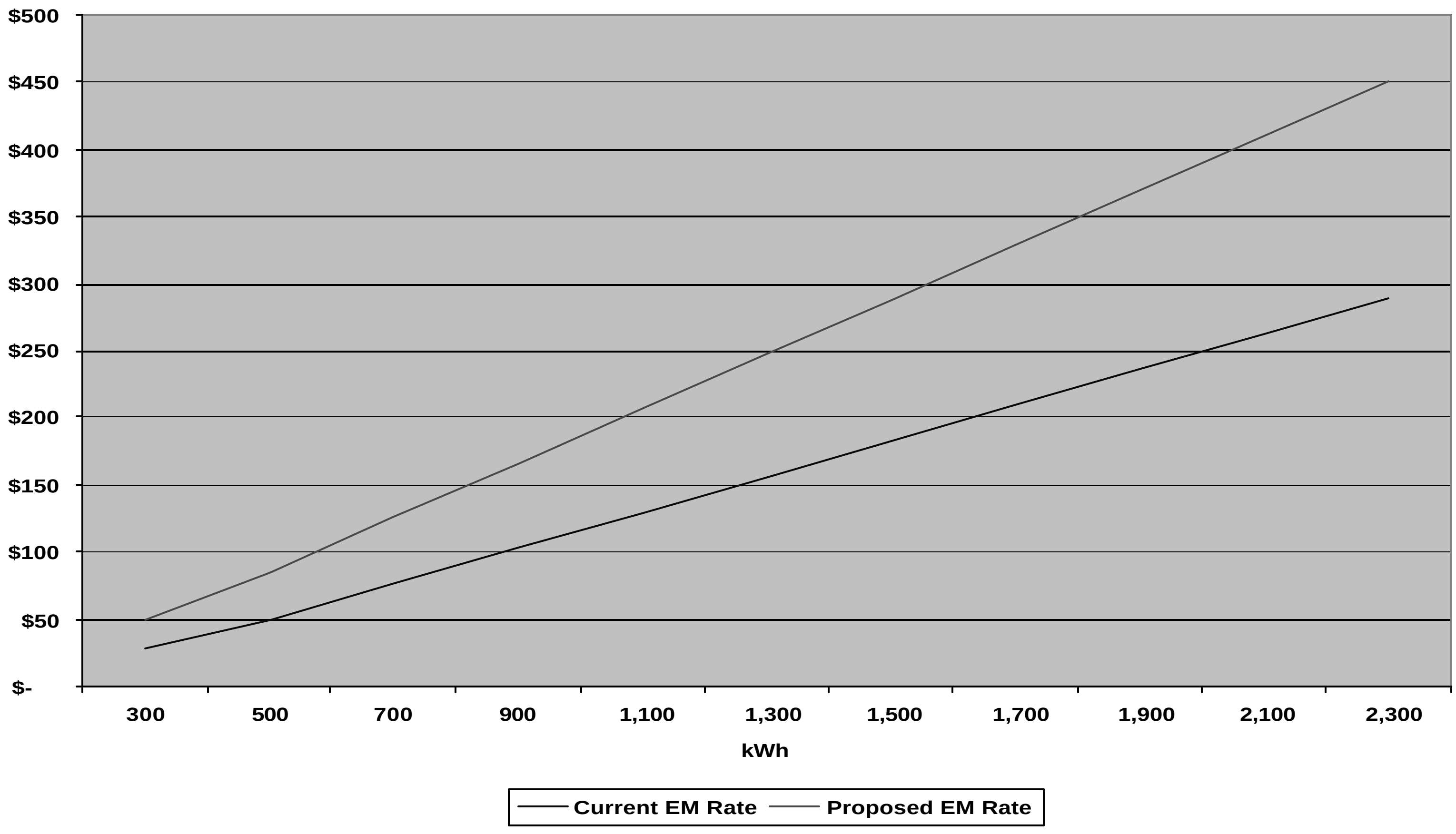
MCA Results - Industrial

	Power COSA	Power Cost	Loss on Sale	MCA Short	Avg MCA
I1	$.0819	$.0414	$.0406	$.0654	$.0499
K large	$.0801	$.0414	$.0387	$.0624	$.0624
K Med	$..0776	$.0581	$.0195	$.0315	$.0315

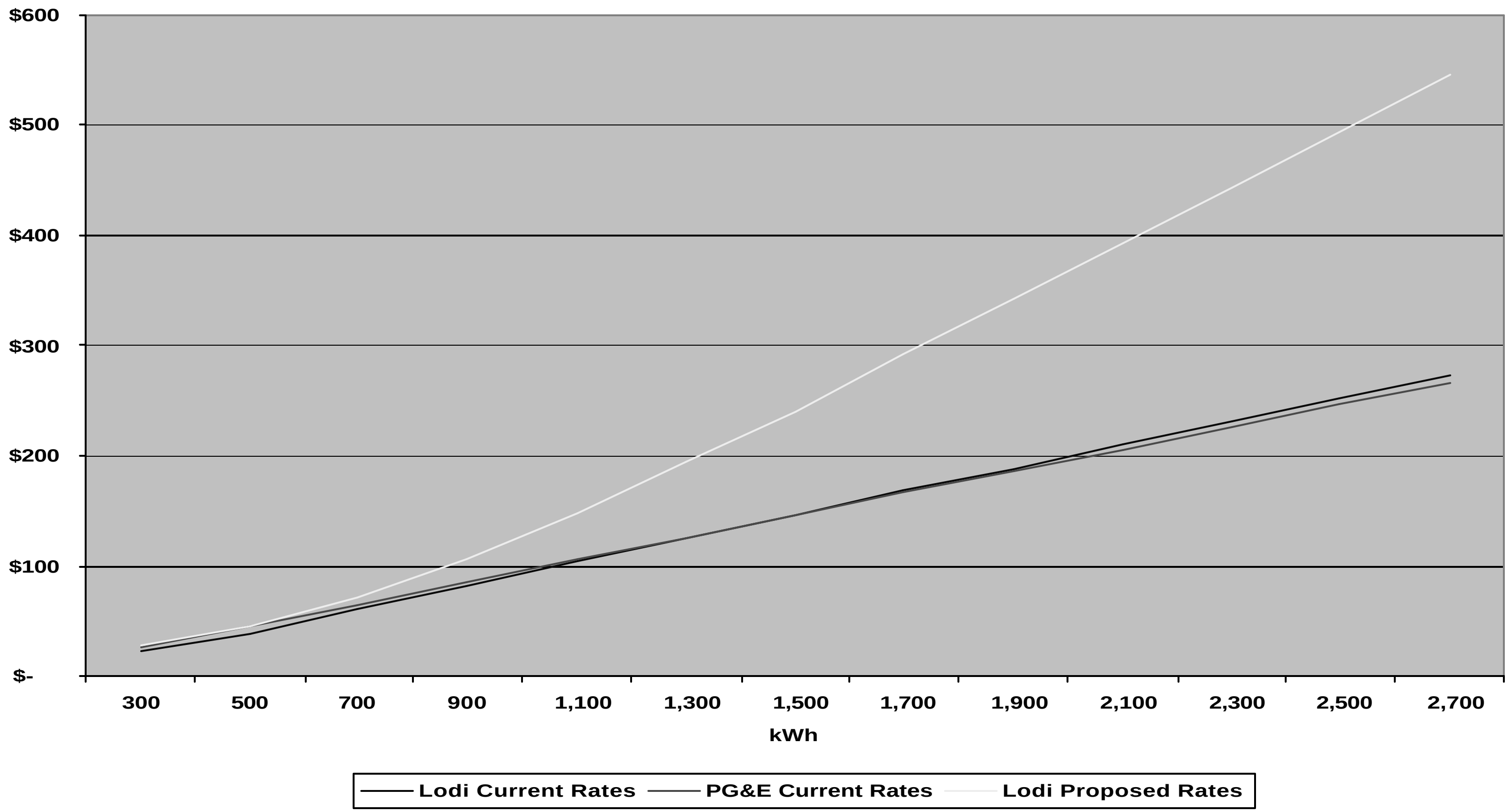
Residential Rates
Current vs Proposed Summer



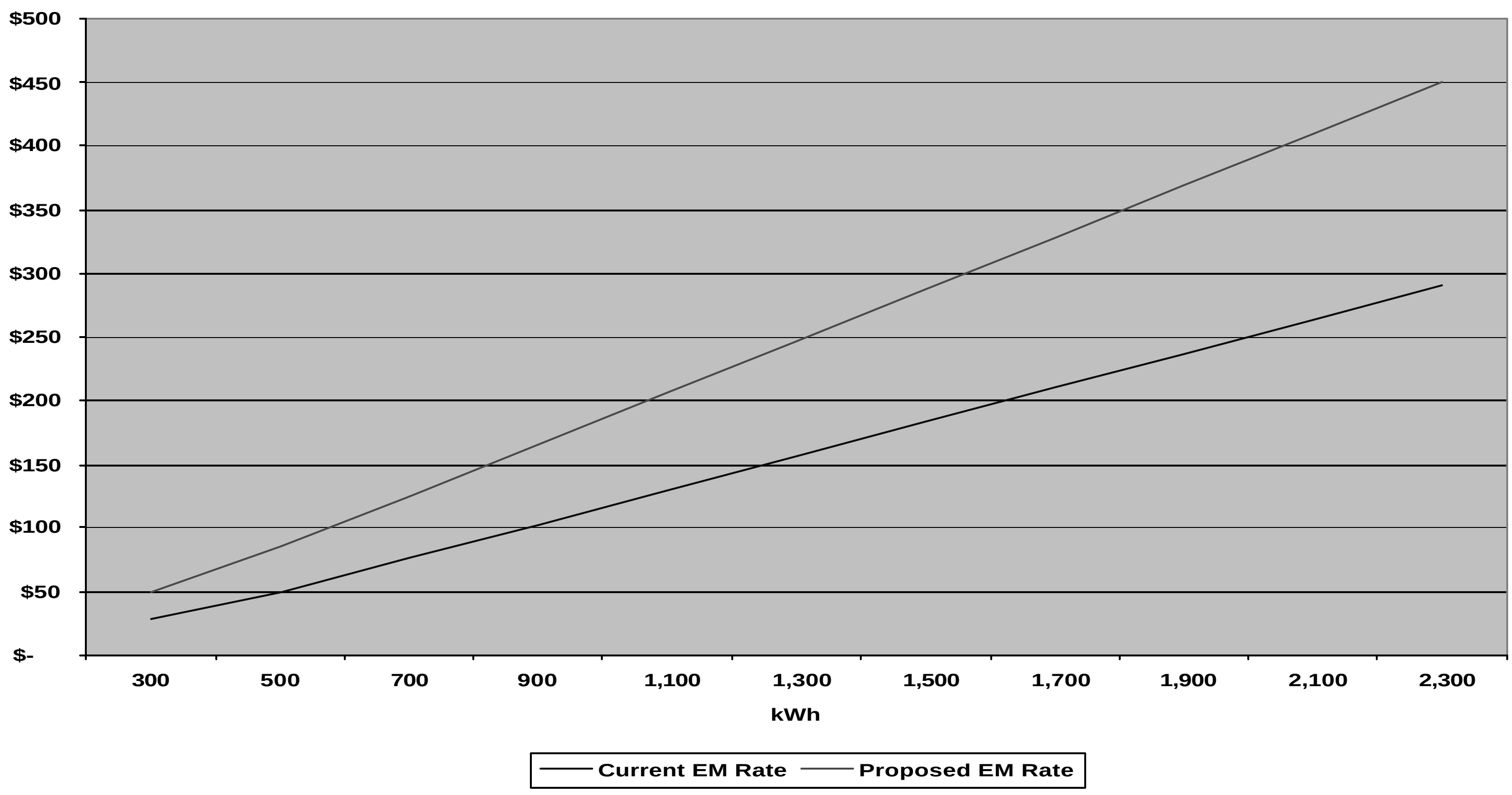
Mobile Home Rate
Current vs Proposed Summer



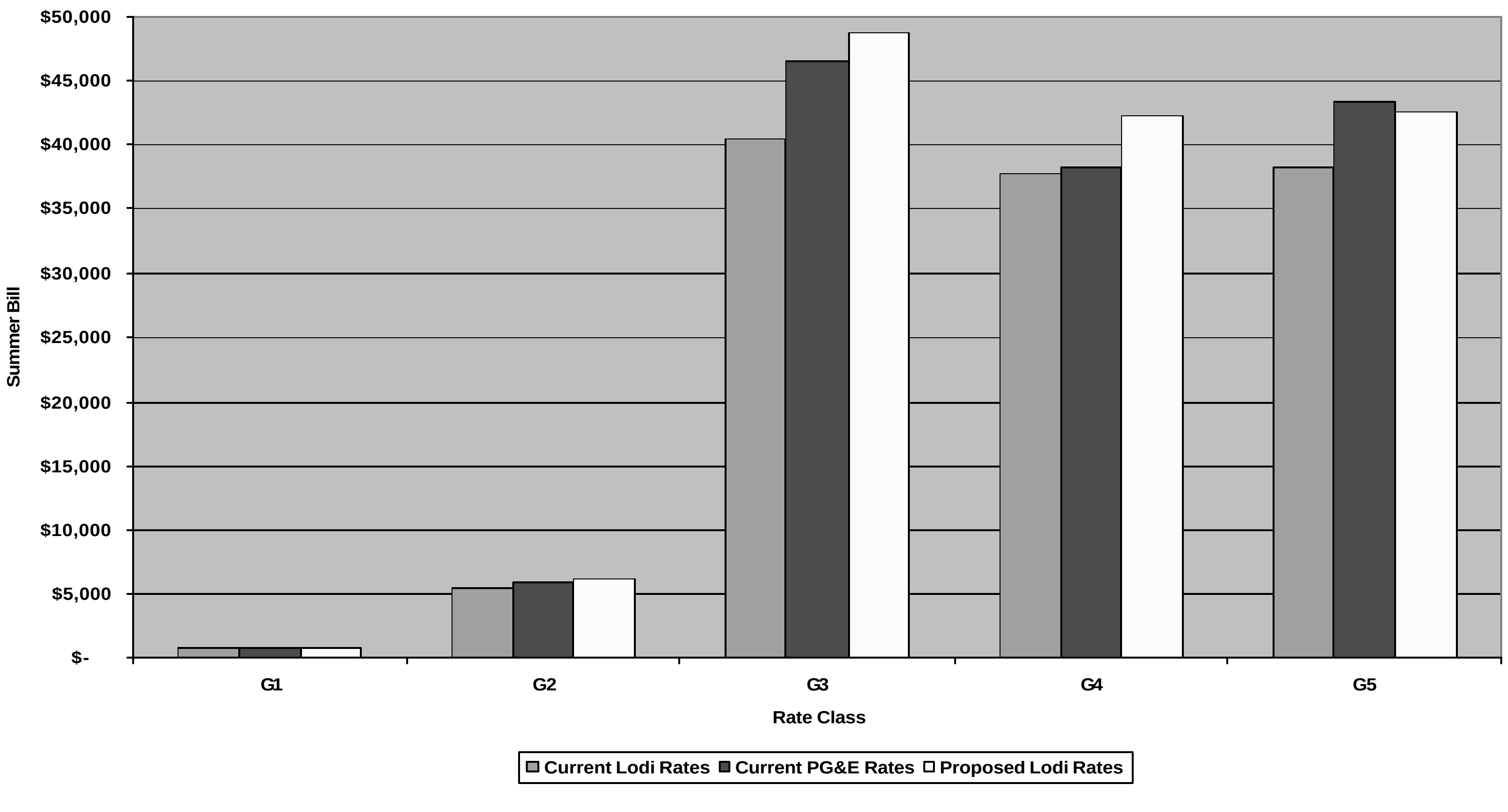
Residential Share
Current vs Proposed Summer



Current Mobile Home Rate vs Proposed Rate



Commercial Industrial Rates Current vs Proposed



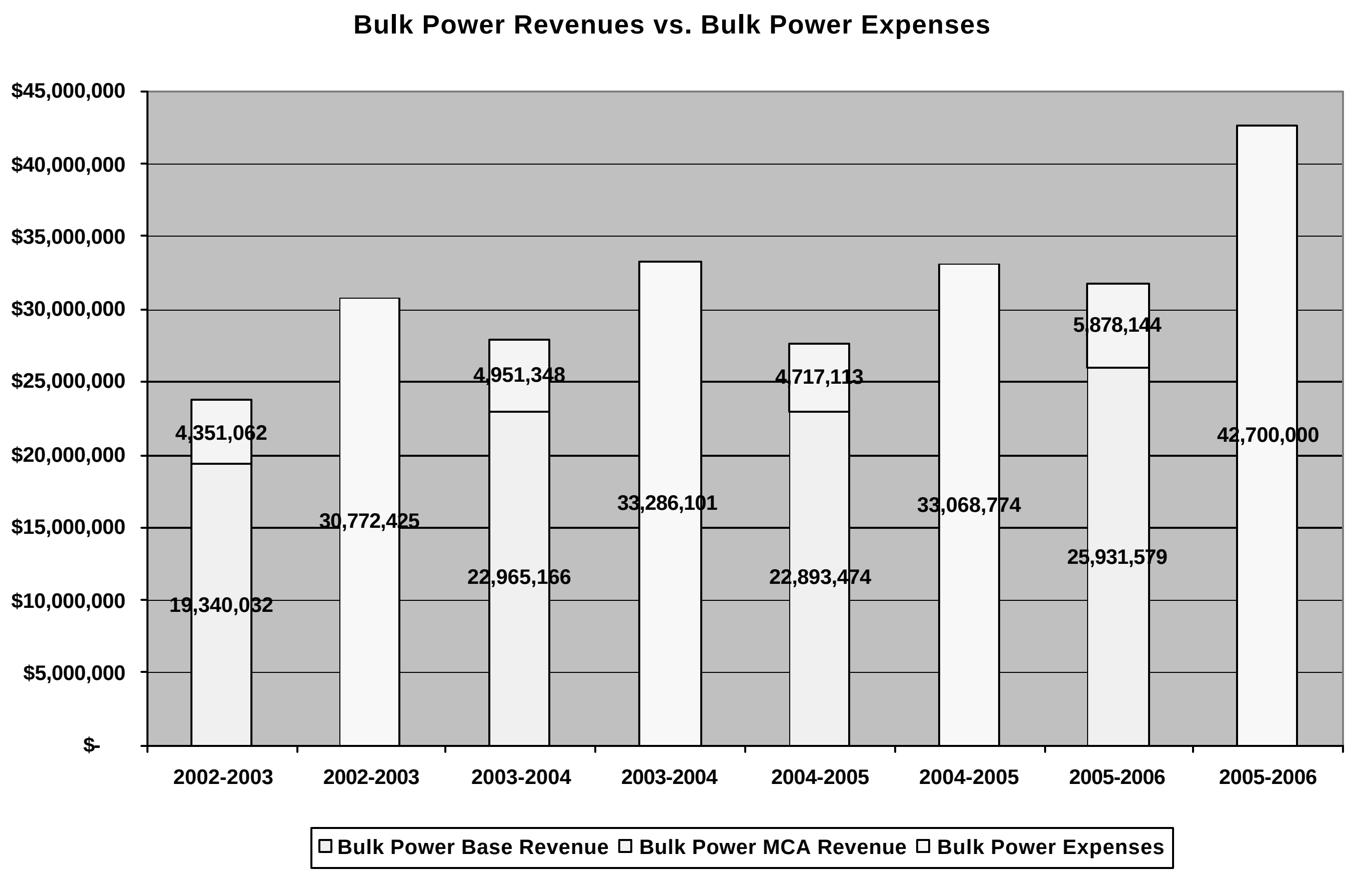
Long Term - Expenses

- More detailed analysis of expenses needed
  - Power supply
    - NCPA cost allocations being revised
    - Large open positions in next fiscal year
      - Resource development costs
    - Repairs to Geo facilities
  - Debt
    - Evaluate interest rate exposure on swaps

Long Term – Expenses (continued)

- Electric O&M expenses
  - Staffing – vacancies/retirements
  - Benchmarking against standard industry metrics
- Capital Improvement Program
  - Identify essential needs and funding sources
  - Identify shortfalls from debt financing (if any)
  - Address Service Center timing, location and integration with other city services

Long Term - Revenues



Concluding Remarks

- MCA provides a mechanism to adjust quickly
  - It can be raised or lowered after detailed study
  - Reduces further losses in income
  - Reduces need for larger increases through delay
  - Provides positive signal to financial rating agencies of city commitment to meet financial obligations

Questions

Cumulative MCA and Rate Change needed by Fiscal Year